June 27, 2016

Q2 2016 Newsletter

Last week, British citizens were given an opportunity officially to have their say via a nonbinding referendum on whether to remain in the European Union ("Bremain") or to leave the European Union ("Brexit"). In a move that surprised global markets, British citizens opted for Brexit in a narrow margin. This is the second time in as many years that macro-economic news in another country at the end of June caused the U.S. stock market, and our portfolio, to drop. Just as we were last year when this decline occurred (due to fears of a slowing Chinese economy), we are unconcerned.

We have read some of the panicked commentary on Brexit as well as some of the more reasoned ones. The panicked ones all include some variation of the word "unprecedented", which is another way of saying "unknown." As we have stated, the market fears the unknown and the uncertainty that it entails. We have seen Brexit being extrapolated to heralding the doom of the European Union ("EU"). Some believe that the EU will want to punish the UK for leaving by negotiating unfavorable treaties, despite the fact that it would also punish the EU, a classic case of "cutting your nose to spite your face."

We subscribe to a different notion – that people tend to act in their own best interest. We actually sympathize with the British citizens who voted on Brexit. We as Americans would never want to be in the EU, so how can we blame the British who voted to leave it?

It did not help market sentiment that world leaders had been trying to scare the British citizens against Brexit, including President Obama saying a stand-alone Great Britain outside of the EU would be at the back of the queue for trade negotiations. We believe these scare tactics were orchestrated to achieve the desired outcome, but only resulted in a panicked response by global markets in the absence of that outcome.

The Wall Street Journal had an insightful opinion piece on Saturday called "A Very British Revolution." It aptly explains the primary reasons for leaving the EU. It boils down to immigration policies and being subject to laws made by an unelected body in a foreign land.

What matters most is what happens next. People have long feared the risk of "contagion" in the EU, whereby one country leaving will trigger a slew of other countries exiting the EU. Great Britain was never part of the monetary union (i.e., the euro), which makes its exit far less of a model for other countries looking to leave.

Over the longer term, we see Brexit as a net benefit to the British and ultimately to the U.S. First, the EU has a little less bargaining power than it did before, which benefits the U.S. Second, Britain will be free to negotiate its own agreements with the U.S., China, or anyone else. Per the Wall Street Journal linked above:

> Deals negotiated through the EU always move at the pace dictated by the most reluctant country. Italy has threatened to derail a trade deal with Australia over a spat about exports of canned

tomatoes; a trade deal with Canada was held up after a row about Romanian visas. Brexit wasn't a call for a Little England. It was an attempt to escape from a Little Europe.

Regarding the new agreements that will be negotiated between the UK and the EU, David Markel, who writes the Aleph Blog (which we have been subscribed to for a while), had some good insights that we agree with:

Governments are smaller than markets; markets are smaller than cultures.

What I am saying is that almost everything affecting the needs of people will get done when there is sufficient freedom. If Brexit occurs, the UK will negotiate some agreement that is mutually beneficial to the UK and the EU, and most things will go on as they do today. Even with a subpar agreement, perfidious Albion is very effective at getting what they need completed. This is especially true of their very effective and creative financial sector in the City of London without which most effective international ~~secrecy, taxation avoidance and regulatory avoidance~~ business could not be done.

Whatever happens, it will happen slowly. Leaving a complex multinational group like the EU takes two years at least. How it all works out in detail is not predictable.

I can say that human systems tend toward stability. People act to preserve the things that they like. Only under severe conditions does that cease to be true, and even then typically only for short periods of time.

I can also say something a little more controversial. Wealth, assets, and money [WAM] act like they are alive and have more votes than people do under most conditions. Why am I saying this?

Governments come in, and go out, but for the most part, the same things get done. Those thinking that radical change will come are usually deeply disappointed. WAM tend to maintain the status quo, not because their owners ~~bribe politicians and suborn regulators~~ pay political action contributions, but because people want the streams of goods and services that help make WAM valuable. Only a genuine crisis at least as large as the Great Depression or the Civil War can create truly radical change that reshapes the basic desires of most of the people in a nation.

Capitalist democracies that respect the rule of law (e.g., the government is also governed by a higher law) are usually pretty stable; systems that don't have significant capitalism or democracy may last a couple generations, but tend to fall apart.

All that said, there is significant economic pressure to do two things after the Brexit:

- Rethink the single currency and common laws
- Maintain a free-ish trade zone in goods and services

The Eurozone does not allow for the necessary economic adjustments across nations in a fiat monetary system. Nations need their own currencies, central banks, etc. They also need to govern themselves via their local culture, not someplace far away with misguided idealists who think they know what's best for all.

Free-ish trade maintains most of what is needed for human needs. The European Union is a political construct meant to prevent war from ever recurring in Europe. The best way to do that is through trade. Severe wars rarely start between nations that rely on each other and interact through commerce.

> My view is that ten years from now, the goods and services that people want will get delivered, regardless of the governmental structures in Europe. I will invest accordingly. [emphasis added]

We listened to an interview from a few months ago in which Warren Buffett gave his thoughts on Brexit. He wanted Britain to remain in the EU, but his reasoning was for stability. The outcome of the vote, however, was not a major concern to him. He told the interviewer that even if he was assured of Bremain, he would do nothing different in either his business's operations or in investing.

What about our portfolio? We are invested in two companies headquartered in the UK with a total exposure heading into the Brexit vote of less than 8% of the portfolio. Both companies have a global presence and are essentially irreplaceable to their customers in the near-to-medium term, resulting in strong durable competitive advantages for both companies. When I went to bed on Thursday night, it was clear that Brexit had won the day. My only thought was greed – I was hoping that the UK stock market would plunge the next day and we would get a chance to add to both of these businesses at reduced prices. Alas, the UK market held up in pounds (both of our UK investments were actually up in pounds on the day!), though the steep drop in the value of the pound relative to the dollar negatively impacted us (though the pound devaluation will benefit the results of both companies over the coming quarters).

What occurred instead was a decline in the rest of the world's markets. While much hyperbole has been applied to the drop in the U.S. market, in reality it was more of a slow bleed. The market dropped a lot more on August 24, 2015 on relatively little news and was at much lower levels in the early months of 2016.

Not all stocks were impacted the same, of course. We kept an eye on stocks we wanted to buy into at better prices. While none dropped enough for us, we still saw drops of 10% for wonderful companies that will not be impacted at all by Brexit. Even Berkshire Hathaway, which Mr. Buffett all but said would not be impacted by Brexit, dropped over 4% on Friday.

As our investors already know, we do not generally care about macroeconomic events. We stay informed and try to understand any major macro-economic news from multiple angles to assess the risk to our portfolio and to the stocks we are analyzing, but we have a long bias toward the world in general. In other words, we feel confident that the world will trudge along as it always has despite the worst that can be thrown at it.

A great comment surfaced on Friday in the midst of the market panic over Brexit from the managers of Tweedy, Browne Global Value Fund, which is included here in its entirety:

> Each bear market seems, when we are in the midst of it, as if it is the end of the world. Unfortunately, most individuals tend to extrapolate current conditions endlessly into the future. Things will change and, in our estimation, for the better. As one philosopher said, the world will only end once and then it does not matter what you own. We are reminded of the time back in 1962 when Russian missiles were on their way to Cuba to confront the U.S. blockade. Joe Reilly, a former partner of Tweedy, Browne, was in our trading room feverishly buying stocks in one of the biggest market meltdowns in stock market history. When asked how he could be so confident

> in the face of such impending doom, Joe remarked, "Either this is going to turn out OK and the markets will turn around, or the world is going to come to an end. In either event, I'll be fine as long as God doesn't require cash."

We could not agree more with those sentiments. It sums up our view on investing perfectly. An even more succinct statement is "This too shall pass." Fears of slowing growth in the Chinese economy caused a similar panic a year ago, also at the end of June. The reasons for those fears have not changed in the last year, but the market has largely forgotten about it.

There will, no doubt, be subsequent dips in the market in the future whenever some negative update comes out on the process of exiting the EU, just as we see occur whenever something negative comes out of any corner of the world. However, as has been proven time and again, those dips do not last forever, or even for very long. Hopefully those dips will afford us an opportunity to pick up a new stock at a great price or to add to an existing position. We stand ready.